## Part F. Tax Abuses--Income Shifting

Although the proposed rate schedule for individuals is flatter than under current law, there would remain a substantial difference between the top and bottom rates. Thus, as under current law, taxpayers subject to the top rate would have an incentive to shift income to their children or other family members subject to tax at lower rates. Current law limits income shifting through various rules, including the assignment-of-income doctrine and the interest-free loan provisions. This Part discusses proposed rules that would buttress current limits on income-shifting by preventing taxpayers from reducing the tax on unearned income by transferring income to minor children or establishing trusts.

## ADJUST TAX RATE ON UNEARNED INCOME OF MINOR CHILDREN

General Explanation

Chapter 3.13

### Current Law

Minor children generally are subject to the same Federal income tax rules as adults. If a child is claimed as a dependent on another taxpayer's return, however, the child's zero bracket amount is limited to the amount of the child's earned income. Accordingly, the child must pay tax on any unearned income in excess of the personal exemption ($1,040 in 1985).

Under current law, when parents or other persons transfer investment assets to a child, the income from such assets generally is taxed thereafter to the child, even if the transferor retains significant control over the assets. For example, under the Uniform Gifts to Minors Act ("UGMA"), a person may give stock, a security (such as a bond), a life insurance policy, an annuity contract, or money to a custodian, who generally may be the donor, for the child. As a result of the gift, legal title to the property is vested in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income. Results similar to those achieved by a transfer under the UGMA may be obtained by transferring property to a trust or to a court-appointed guardian.

Parents also may shift income-producing assets to a child, without relinquishing control over the assets, by contributing such assets to a partnership or S corporation and giving the child an interest in the partnership or corporation.

### Reasons for Change

Under current law, a family may reduce its aggregate tax liability by shifting income-producing assets among family members. Such "income shifting" is a common tax-planning technique, typically accomplished by the parents transferring assets to their children so that a portion of the family income will be taxed at the child's lower marginal tax rate.

Income shifting undermines the progressive rate structure, and results in unequal treatment of taxpayers with the same ability to pay tax. A family whose income consists largely of wages earned by one or both parents pays tax on that income at the marginal rate of the parents. Even though such wage income is used in part for the living expenses of the children, parents may not allocate any portion

of their salary to their children in order that it be taxed at the children's lower tax rates. Families with investment income, however, may be financially able to transfer some of it to the children, thereby shifting the income to lower tax brackets. Typically, this ability is most prevalent among wealthy taxpayers. Moreover, use of a trust or a gift under the UGMA allows the parents to achieve this result without relinquishing control over the property until the children come of age.

The opportunity for income shifting also complicates the financial affairs of persons who take advantage of it, and causes some persons to make transfers they would not make absent tax considerations. Disputes with the Internal Revenue Service are created in the case of transfers that arguably are ineffective in shifting the incidence of taxation to the transferee, such as when a parent nominally transfers property to children but in reality retains the power to revoke the transfer.

Proposal

Unearned income of children under 14 years of age that is attributable to property received from their parents would be taxed at the marginal tax rate of their parents. This rule would apply only to the extent that the child's unearned income exceeded the personal exemption ($2,000 under the Administration proposals). The child's tax liability on such unearned income would be equal to the additional tax that his or her parents would owe if such income were added to the parents' taxable income and reported on their return. If the parents report a net loss on their return, the proposed rule would not apply, and the child's unearned income would be taxed along with his or her earned income. If more than one child has unearned income which is taxable at the parents' rate, such income would be aggregated and added to the parents' taxable income. Each child would then be liable for a proportionate part of the incremental tax.

All unearned income of a child would be treated as attributable to property received from a parent, unless the income is derived from a qualified segregated account. A child who receives money or property from someone other than a parent, such as another relative, or who earns income, could place such property or earnings into a qualified segregated account. Property received by reason of the death of a parent could also be placed into the account. However, other amounts otherwise received directly or indirectly from a parent could not be placed into the account.

For purposes of this provision, an adopted child's parents would be the adoptive parent or parents. In the case of a foster child, the parents would be either the natural parents or the foster parents, at the child's election. If the parents are married and file a joint return, the child's tax would be computed with reference to the parents' joint income. If the parents live together as of the close of the taxable year, but do not file a joint return (i.e., if they are

married and file separate returns or if they file as single individuals), then the child's tax would be computed with reference to the income of the parent with the higher taxable income. If the parents do not file a joint return and are not living together as of the close of the taxable year, the child's tax would be computed with reference to the income of the parent having custody of the child for the greater portion of the taxable year.

Expenses that are properly attributable to the child's unearned income would be allowed as deductions against such income. Itemized deductions and the personal exemption generally would be allocated between earned and unearned income in any manner chosen by the taxpayer. Interest expense, however, would be deductible against unearned income that is taxable at the parents' tax rate only if it is attributable to debt that was assumed by the child in connection with a transfer of property from the parents, or to debt that encumbered such property at the time of the transfer.

Earned income and income from a qualified segregated account would be taxable (after subtracting the portion of the child's itemized deductions and personal exemption allocated to such income) under the rate schedule applicable to single individuals, starting at the lowest rate. Moreover, unlike current law, the zero bracket amount could be used against both the child's earned income and unearned income from a segregated account, although it could not be used to offset other unearned income.

The proposed taxation of income of children under 14 years of age may be illustrated by the following example.

Suppose Sarah, aged 13, earns $500 from a paper route in 1984. She has $4,000 in a bank account, attributable to savings from her earned income and gifts from her grandparents. She earns $360 in interest from the account. She also earns $1,000 from an account set up by her parents under the Uniform Gifts to Minors Act. Under current law, Sarah's unused zero bracket amount is $2,300 less $500, or $1,800. This amount must be added to her income. Thus, Sarah's income is:

| |
|---|
| $ 500 |
| 360 |
| 1,000 |
| 1,800 |
| $3,660, less $1,000 personal exemption = $2,660. |

In 1984, the tax on taxable income of $2,660 is $39.60. Sarah must file a return and pay this tax.

Under the proposal (assuming 1984 levels of the zero bracket amount and personal exemption), Sarah would not have to file a return, because her income taxable at her parents' rate ($1,000) is not in excess of her personal exemption, and her other income ($860) is not

in excess of the zero bracket amount. If her parents placed more money in her name she would have to file a return. Even then, however, only one rate would apply to her income, namely that of her parents.

## Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

## Analysis

The proposal would help to ensure the integrity of the progressive tax rate structure, which is designed to impose tax burdens in accordance with each taxpayer's ability to pay. Families would be taxed at the rate applicable to the total earned and unearned income of the parents, including income from property that the parents have transferred to the children's names. The current Federal income tax incentive for transferring substantial amounts of investment property to minor children would be eliminated.

Under the proposal, the unearned income of a minor child under 14 years of age would be taxed at his or her parents' rate. This is the age at which children may work in certain employment under the Fair Labor Standards Act. Because most children under 14 have little or no earned income, maintenance of segregated accounts and preparation of their returns under the proposal should not be complex.

In most cases the income tax return of a child under 14 years of age is prepared by or on behalf of the parent and signed by the parent as guardian of the child. In such cases, the requirement that a child's income be aggregated with that of his or her parents would not create a problem of confidentiality with respect to the parents' return information, since there would be no need to divulge this information to the child. Although the return generally would be filed by a parent on behalf of a child, liability for the tax would rest, as under current law, on the child.

Only children required to file a return under current law would be required to do so under the proposal. In 1981, only 612,000 persons who filed returns reporting unearned income were claimed as dependents on another taxpayer's return. This represents less than one percent of the number of children claimed as dependents in that year. Moreover, in many instances the proposal would eliminate tax liability for children who currently must file a return because they cannot use the zero bracket amount to offset unearned income that is not attributable to property received from their parents.

## REVISE GRANTOR AND NON-GRANTOR TRUST TAXATION

General Explanation

Chapter 3.14

### Current Law

#### In General

The manner in which the income from property held in trust is taxed depends upon the extent to which the grantor has retained an interest in the trust. A so-called "grantor trust," a trust in which the grantor has retained a statutorily defined interest, is treated as owned by the grantor and the trust's income is taxable directly to the grantor. Non-grantor trusts, including "Clifford trusts," on the other hand, are treated as separate taxpayers for Federal income tax purposes, with trust income subject to a separate graduated rate structure.

The rules for determining whether a trust will be treated as a grantor trust are highly complex. In general, however, the test is whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. For example, to the extent that the grantor (or a party whose interests are not adverse to the grantor) has the right to vest the trust's income or assets in the grantor, the trust will be treated as a grantor trust. Similarly, to the extent that the trust's assets or income may reasonably be expected to revert to the grantor within ten years of the trust's creation, the trust will generally be treated as a grantor trust.

In general, the income of a non-grantor trust is subject to one level of tax; it is taxable either to the trust itself or to the beneficiaries of the trust. Under this general model, trust income is included as gross income of the trust, but distributions of such income to trust beneficiaries are deductible by the trust and includable in the income of the beneficiaries.

The maximum distribution deduction permitted to a trust, and the maximum amount includable in the income of trust beneficiaries, is the trust's distributable net income ("DNI"). A trust's DNI consists of its taxable income computed with certain modifications, the most significant of which are the subtraction of most capital gains and the addition of any tax-exempt income earned by the trust.

To the extent that a trust distribution carries out DNI to a beneficiary, the trust essentially serves as a conduit, with the beneficiary taking into account separately his or her share of each trust item included in DNI. Under a complex set of rules, the computation of each beneficiary's share of an item of trust income

generally depends upon the amount distributed to the beneficiary and the "tier" to which the beneficiary belongs. A distribution that does not carry out DNI -- such as one in satisfaction of a gift or bequest of specific property or a specific sum of money, or one in excess of DNI -- is not deductible by the trust and is not includable in the recipient's income. Similarly, because capital gains generally are excluded from the computation of DNI, a trust ordinarily is subject to taxation on the entire amount of its capital gain income even when it distributes an amount in excess of its DNI.

### Adoption of Taxable Year

The trustee of a non-grantor trust may select a year ending on the last day of any month as the trust's taxable year. Although a trust distribution that carries out DNI is generally deductible by the trust in the taxable year during which it is made, the distribution is not taxable to the beneficiary until his or her taxable year with which or in which the trust's taxable year ends. Thus, for example, if an individual is a calendar-year taxpayer and is the beneficiary of a trust with a taxable year ending January 31, distributions made by the trust with respect to its year ending January 31, 1984, will not be subject to tax until the beneficiary's year ending December 31, 1984, even if they were made as early as February 1983.

### Throwback Rules

The so-called "throwback rules" are applicable only to trusts that accumulate income rather than distribute it currently to the beneficiaries. These rules limit the use of a trust as a device to accumulate income at a marginal tax rate lower than that of the trust's beneficiaries. DNI that is accumulated rather than distributed currently becomes undistributed net income ("UNI") and may be subject to additional tax when distributed to the beneficiaries.

The rules for determining the amount, if any, of such additional tax are complex. In general, however, if a trust's current distributions exceed its DNI and the trust has UNI from prior taxable years, the excess distributions (to the extent of UNI), increased by the taxes paid by the trust on such distribution, will be taxed at the beneficiary's average marginal tax rate over a specified period preceding the distribution as reduced by a credit for the tax paid by the trust on such distribution.

## Reasons for Change

### Taxpayer Fairness

Present law permits a grantor to shift income to family members through creation of a trust, even when the grantor retains significant control over or a beneficial interest in the trust's assets. For example, trust income is not taxed to the grantor even though the trust's assets will revert to the grantor as soon as ten years after the trust's creation. Similarly, trust income is not taxed to the

grantor even though the grantor appoints himself or herself as trustee with certain discretionary powers to accumulate income or distribute trust assets. Significantly broader discretion over trust income and distributions may be vested in an independent trustee, who, although not formally subject to the grantor's control, may be expected to exercise his or her discretion in a manner that minimizes the aggregate tax burden of the trust's grantor and beneficiaries.

During the lifetime of the grantor, there is no persuasive justification for taxing a trust under its own graduated rate schedule. Permitting a grantor to create trusts and thereby obtain the benefit of multiple graduated rate schedules is inconsistent with the principle that all income of an individual taxpayer should be subject to tax under the same progressive rate structure. A trust is simply an arrangement established by the grantor to manage investment assets and to allocate the income from those assets to beneficiaries. Where the grantor has effectively divested himself of control and enjoyment of trust income is irrevocably fixed or determined, such income should be taxed to the beneficial owners of the trust. Where this divestment has not taken place, however, the trust's income should be included in the grantor's income or taxed at the grantor's marginal tax rate.

On the other hand, after the grantor's death it may not be unreasonable to respect trusts as separate taxable entities. In such instances, it is likely that non-tax factors outweigh any Federal income tax considerations in the grantor's decision whether to create a trust. For example, it is reasonable to assume that a grantor creating an inter vivos trust with discretion in the trustee over the ultimate beneficiary of the property is creating the trust, at least in substantial part, to obtain preferential income tax treatment; ordinarily, the grantor could accomplish most of the non-tax objectives for the creation of the trust by retaining the property. At the least, the tax system should not create a preference for utilizing the trust vehicle. In contrast, a trust may be the only form in which to preserve such discretion and flexibility after the grantor's death. Precise rules that would define when post-death trusts would be granted the benefit of separate graduated rate schedules would be complex and would lead to harsh results in many cases.

Efficiency and Simplification

The significant income-splitting advantages that may be gained by placing income-producing assets in trust have resulted in greater utilization of the trust device than would be justified by non-tax economic considerations. Moreover, even where there are non-tax reasons for a trust's creation, tax considerations heavily influence the trustee's determination of whether to accumulate or distribute trust income. No discernable social policy is served by this tax incentive for the creation of trusts and the accumulation of income within them. Thus, current tax policy has not only sacrificed tax

revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property. In addition, the fact that the tax benefits of the trust form can be increased through the creation of multiple trusts has resulted in the creation of numerous trusts with essentially similar dispositive provisions.

The tax advantages that current law provides to trusts also have spawned a complex array of anti-abuse provisions. The grantor trust rules and the throwback rules are highly complex and often arbitrary in their application. Rules that attribute capital gain of certain non-grantor trusts to the grantor are also complex in operation and can have unforeseen consequences to trust grantors.

## Proposal

### Taxation of Trusts During Lifetime of Grantor

#### 1. Overview

During the lifetime of the grantor, all trusts created by the grantor would be divided into two categories: trusts that are treated as owned by the grantor for Federal income tax purposes, because the grantor has retained a present interest in or control over the trust property; and trusts that are not treated as owned by the grantor, because the grantor does not have any present interest in or control over the property. As under current law, the income of a trust classified as a grantor-owned trust generally would be taxed directly to the grantor to the extent that the grantor is treated as the owner. A non-grantor-owned trust generally would be respected as a separate taxable entity. During the grantor's lifetime, however, income would be taxed to the trust at the grantor's marginal tax rate, unless the trust instrument requires the income to be distributed to or irrevocably set aside for specified beneficiaries.

#### 2. Grantor-owned trusts

The grantor would be treated as the owner of a trust to the extent that (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be

characterized as "adverse parties" under present law. In addition, a United States person who transfers property to a foreign trust having one or more U.S. beneficiaries would continue to be treated as the owner of the portion of the trust attributable to that property to the extent required under present law.

The present law rules under which a person other than the grantor may be treated as owner of a trust would be retained and made consistent with these rules. A grantor or other person who is treated as the owner of any portion of a trust under these rules would be subject to tax on the income of such portion. Transactions between the trust and its owner would be disregarded for Federal income tax purposes where appropriate.

3. Non-grantor-owned trusts

(a) In general. A trust that is not treated as owned by the grantor or by any other person under the rules described above would be subject to tax as a separate entity. Unlike present law, however, non-grantor-owned trusts would be required to adopt the same taxable year as the grantor, thereby limiting the use of fiscal years by trusts to defer the taxation of trust income.

The trust would compute its taxable income in the same manner as an individual, but would not be entitled to a zero bracket amount or a personal exemption (or deduction in lieu of a personal exemption). As under current law, the trust would be entitled to a deduction for charitable contributions made within 65 days of the close of the trust's taxable year.

(b) Distribution deduction. The present rules regarding the deductibility of distributions made by a trust to non-charitable beneficiaries would be substantially changed. First, during the lifetime of the grantor, only mandatory distributions would be deductible by a trust. A distribution would qualify for this deduction only if a fixed or ascertainable amount of trust income or property is required to be distributed to a specific beneficiary or beneficiaries. As under present law, distributions required to be made would be deductible regardless of whether actually made by the trustee.

The amount of a mandatory distribution would be considered fixed or ascertainable if expressed in the governing instrument as a portion or percentage of trust income. The requirement that each beneficiary's share be fixed or ascertainable also would be satisfied by a requirement that distributions be made on a per capita or per stirpital basis that does not give any person the right to vary the beneficiaries' proportionate interests. Thus, distributions would not qualify as mandatory if the governing instrument requires the distribution of all income among a class of beneficiaries, but gives any person the right to vary the proportionate interests of the members of the class in trust income.

A distribution would be considered mandatory if required upon the happening of an event not within the control of the grantor, the grantor's spouse, or the trustee, such as the marriage of a beneficiary or the exercise by an adult beneficiary of an unrestricted power of withdrawal. The requirement that the governing instrument specify the beneficiary or beneficiaries of a mandatory distribution would be satisfied if a class of beneficiaries were specified and particular beneficiaries could be added or removed only upon the happening of certain events not within the control of the grantor, grantor's spouse, or trustee, such as the birth or adoption of a child, marriage, divorce, or attainment of a certain age.

Second, unlike present law, property required to be irrevocably set aside for a beneficiary would be treated as a mandatory distribution, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, or is subject to a power exercisable by the beneficiary the possession of which will cause the property to be included in the beneficiary's gross estate for Federal estate tax purposes. Thus, the trustee could designate property as irrevocably set aside for a beneficiary and obtain a distribution deduction (provided that a distribution or set-aside is mandatory under the governing instrument) without making an actual distribution to the beneficiary. To qualify for the set-aside deduction, the beneficiary would have to agree to include the amount in income.

If the tax imposed on a beneficiary by reason of a set-aside exceeds the amount actually distributed to the beneficiary in any year, and if the governing instrument permits the beneficiary to obtain a contribution from the trustee equal to the tax liability imposed by reason of the set-aside (less any amounts previously distributed to the beneficiary during the taxable year), such contribution would be treated as paid out of the amount set aside, and therefore would not carry out additional DNI. This structure, unlike present law, would permit a fiduciary to obtain the benefit of a beneficiary's lower tax bracket through an irrevocable set-aside. Accordingly, tax motivations would not override non-tax factors which might indicate that an actual distribution is undesirable.

Third, whether mandatory or not, distributions to non-charitable beneficiaries would not be deductible during the lifetime of the grantor under the following circumstances indicating incomplete relinquishment of interest in or dominion and control over the trust:

(i) If any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse;

(ii) If any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such

portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or the funding of the trust;

(iii) If any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a non-fiduciary capacity without the consent of a fiduciary;

(iv) If and to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or

(v) If trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.

(c) Computation of tax liability. Once the taxable income of a non-grantor inter vivos trust has been computed under the rules described above, the trust's tax liability would be determined. This liability would be the excess of (i) the tax liability that would have been imposed on the grantor had the trust's taxable income been added to the greater of zero or the grantor's taxable income and reported on the grantor's return, over (ii) the tax liability that is actually imposed on the grantor. Thus, the trust's tax liability generally would equal the incremental amount of tax that the grantor would have paid had the trust been classified as a grantor trust, with two exceptions. First, to avoid the difficulty associated with any recomputation of a grantor's net operating loss carryover and other complexities, if the grantor has incurred a loss in the taxable year or in a prior taxable year, such loss would be disregarded and the grantor would be deemed to have a taxable income of zero for purposes of computing the trust's tax liability. Second, the addition of the trust's taxable income to the taxable income of the grantor would not affect the computation of the grantor's taxable income. For example, trust income would not be attributed to the grantor for purposes of determining the grantor's floor on various deductions.

If the grantor has created more than one non-grantor trust, then each such trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income. If one or more trusts do not cooperate with the grantor and other trusts created by the grantor in determining their tax liability under these rules, the trusts failing to cooperate would be subject to the highest marginal rate applicable to individuals. Similarly, if the grantor does not provide a trustee with information sufficient to enable the trustee to compute the trust's tax liability under these rules, the trustee would be required to assume (for purposes of computing the trust's tax) that

the grantor had taxable income placing him or her in the highest marginal rate.

(d) Taxation of beneficiaries. As under current law, distributions to beneficiaries that are deductible by a trust would be taxable to the beneficiaries, with the trust's DNI representing the maximum amount deductible by the trust and includable in the income of the beneficiaries. Capital gain deemed to be distributed would be included in the computation of the trust's DNI. Capital gain income would be deemed to be distributed if the trust instrument requires that it be distributed or if and to the extent that mandatory distributions and set-asides exceed DNI (as computed without regard to such gain). Each recipient of a required distribution or set-aside would take into account his or her proportionate share of DNI. Thus, the tier rules of present law would be eliminated. Each item entering the computation of DNI, including capital gains that are deemed to be distributed and hence are included in DNI, would be allocated among the beneficiaries and the trust, based on the proportionate amounts distributed to or set aside for each beneficiary.

(e) Multiple grantors. For purposes of determining whether the grantor is the owner of any portion of a trust, and for purposes of determining whether a mandatory distribution is deductible, a trust having more than one grantor would be treated as consisting of separate trusts with respect to each grantor. If a husband and wife are both grantors with respect to a trust, however, they would be entitled to elect one of them to be treated as the grantor with respect to the entire trust for all Federal income tax purposes, such as determining the marginal rate of the trust and the treatment of the trust as a lifetime or post-death trust. The election would have to be made on the trust's first income tax return. Once made, such an election would be irrevocable and would apply to all subsequent transfers to such trust made during the course of the marriage by either spouse.

**Taxation of Trusts After Death of Grantor**

For all taxable years beginning after the death of an individual, all inter vivos and testamentary trusts established by such individual would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and with a distribution deduction for all distributions, whether mandatory or discretionary, actually made to or for non-charitable beneficiaries. As under present law, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. A similar rule would apply to set-asides. Charitable contributions would be deductible as under current law. All trusts would compute DNI in the same manner as non-grantor inter vivos trusts. Any taxable income of the trust would be subject to tax under a graduated rate schedule which is the same as that for married individuals filing separately.

In order to prevent the use of such post-death trusts as income-splitting devices, the throwback rules of present law would continue to apply. Because the present throwback rules often do not fully recapture the tax savings from the accumulation of income within the trust, consideration would be given to provisions such as the imposition of an interest charge on the tax payable with respect to an accumulation distribution and the application of the throwback rules to income accumulated while the beneficiary is under 21 years of age and to capital gain income. In addition, consideration would be given to a more restrictive multiple trust rule to limit the tax benefits of the trust form where two or more trusts have any common primary beneficiaries.

In order to simplify the transition of inter vivos trusts to the post-death rules and to achieve consistent treatment with the decedent's estate (see Ch. 3.15), a trust created during the grantor's lifetime would continue to be treated as an inter vivos trust through the end of the taxable year in which the grantor's death occurs. Thus, for the taxable year in which the grantor's death occurs, income of a grantor-owned trust would be taxed to the grantor. Similarly, during the grantor's final taxable year, a non-grantor-owned inter vivos trust would compute its taxable income in the same manner as before the death of the grantor. Accordingly, such a trust would be entitled to a deduction for qualifying distributions to charity and for all mandatory distributions or set-asides with respect to non-charitable beneficiaries. The trust's taxable year would not terminate with the death of the grantor and the trust would compute its tax liability for the grantor's final year by reference to the taxable income of the grantor.

Testamentary trusts would compute their income using the same taxable year as the decedent and the decedent's estate. A testamentary trust created before the end of the taxable year of the decedent's death would compute its tax liability for its first (short) taxable year along with all other trusts created by the decedent, by reference to the decedent's taxable income for that year.

**Effective Date**

The proposal would apply generally to irrevocable trusts created after 1985 and to trusts that are revocable on January 1, 1986, for taxable years beginning on or after January 1, 1986. A trust that is irrevocable on January 1, 1986, would nevertheless be treated as created after 1985 if any amount is transferred to such trust by a grantor after such date. Similarly, a trust that is revocable on January 1, 1986, and that becomes irrevocable after such date would be treated as a new trust for purposes of these rules.

For trusts that are irrevocable on January 1, 1986, the proposal would apply according to the following rules. Trusts that are grantor trusts under present law would be subject to the new rules beginning with the first taxable year of the grantor that begins on or after January 1, 1986. If a trust that is classified as a grantor trust

under present law is classified as a non-grantor trust under the new rules, however, it would be entitled to elect to be treated as if the grantor were the owner for Federal income tax purposes (such election to be made jointly by the grantor and the trustee).

With respect to trusts that are irrevocable on January 1, 1986, and are not classified as grantor trusts under present law, the proposal would apply to taxable years beginning on or after January 1, 1986, with the following exceptions. First, if such a trust has already validly elected a fiscal year other than the grantor's taxable year on a return filed before January 1, 1986, the trust would be entitled to retain that year as its taxable year. In a case where the grantor and the trust have different taxable years, the trust would compute its tax liability by reference to the grantor's income for the grantor's taxable year ending within the taxable year of the trust. Second, such trusts would be entitled to a distribution deduction for all distributions and set-asides, whether discretionary or mandatory, made during the grantor's lifetime. Finally, such trusts would be entitled to elect to continue the tier system of present law for allocating DNI among trust beneficiaries.

## Analysis

The proposal would limit the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

The proposal would, in general, permit the use of non-grantor inter vivos trusts to shift income among family members only if distributions or set-asides are mandatory and only if the grantor has effectively relinquished all rights in the trust property (other than the exercise of certain powers as trustee). With respect to such a trust, present law would be liberalized in that amounts irrevocably set aside for a beneficiary would be treated as actually distributed. At the same time, wholly discretionary distributions would be ineffective to shift income to trust beneficiaries regardless of the identity of the trustee.

The proposal also would result in substantial simplification of the rules for taxation of trust income. The tier system and the special rule taxing some trust capital gains to the grantor would be repealed. The throwback rules would no longer be applicable to any trust income accumulated during the grantor's lifetime after 1985. Similarly, it would not be necessary to apply the multiple trust rules until after the year in which the grantor's death occurs. Requiring virtually all new trusts to use a calendar year would eliminate the unwarranted tax advantage often created by the selection of fiscal years. The simplicity created by these rules would more than offset whatever complexity is created by taxing inter vivos trusts at the grantor's marginal rate in certain circumstances.

The removal of the artificial tax advantages of trusts would cause decisions regarding the creation of trusts to be based on non-tax considerations. For example, because the income of a ten-year "Clifford" trust would be taxed at the grantor's marginal rate with no distribution deduction, such trusts would be created only where warranted by non-tax considerations. Because many inter vivos trusts are created solely for tax reasons, fewer such trusts would be established under the proposed rules, thus simplifying the financial affairs of taxpayers and reducing the number of trust income tax returns that have to be filed. At the same time, however, the proposal would not impose a tax penalty on the use of a trust to hold and to manage a family's assets. As a general rule, during the grantor's lifetime, accumulated trust income would be taxed as if the grantor had not established the trust. After the grantor's death, a more liberal treatment allowing a graduated rate schedule to the trust would apply. This treatment reflects the substantial non-tax considerations that affect how an individual disposes of his or her estate. Moreover, after the death of the grantor, all trusts created by the grantor would be taxed in the same manner as the grantor's estate; as a result, the proposal would not affect an individual's decision whether to use a trust to avoid probate.

## REVISE INCOME TAXATION OF ESTATES

General Explanation

Chapter 3.15

### Current Law

Under present law, a decedent's estate is recognized as a separate taxable entity for Federal income tax purposes. The separate existence of the estate begins with the death of the decedent, and the estate computes its income without regard to the decedent's taxable income for the period prior to the decedent's death. Because the estate's separate existence begins with the decedent's death, the estate is entitled to adopt its own taxable year without regard to the taxable year of the decedent or the taxable year of any beneficiary of the estate. Furthermore, any trust created by the decedent's will is entitled to select its own taxable year without regard to the taxable year selected by the estate.

An estate generally computes its income in the same manner as an individual, with a $600 deduction allowed in lieu of the personal exemption. The amount of tax on an estate's income generally is determined in the same manner as a trust -- with a deduction allowed for distributions not in excess of distributable net income ("DNI") -- except that the throwback rules applicable to trusts do not apply to estates. Thus, an estate can accumulate taxable income using its separate graduated rate structure and distribute the income in a later year free of any additional tax liability.

Under present law, the decedent's final return includes all items properly includable by the decedent in income for the period ending with the date of his death. The tax paid with this return is generally deductible as a claim against the estate for Federal estate tax purposes. For Federal income tax purposes, all income received or accrued after the date of death is taxed to the estate rather than the decedent. The decedent's surviving spouse may elect, however, to file a joint Federal income tax return for the taxable year in which the decedent's death occurs.

### Reasons for Change

The availability to an estate of a taxable year other than the calendar year creates tax avoidance opportunities. By appropriately timing distributions to beneficiaries of the estate, tax on income generated in the estate may be deferred for a full year. This deferral potential is exacerbated through the use of different fiscal years by testamentary trusts. Estates can also use "trapping distributions" to allocate estate income among the maximum number of taxpayers and thereby minimize the aggregate tax burden imposed on estate income.

The current rules for taxation of income during the taxable year in which the decedent dies create additional distortions. There is no necessary correlation between the timing of items of income and deduction and the date of death. Thus, for example, deductible expenses incurred prior to the date of death are not matched against income received after the date of death. This can result in the wasting of deductions on the decedent's final return or the stacking of income in the decedent's estate.

## Proposal

The rules governing the taxation of estates would be changed so that the decedent's final taxable year would continue through the end of the taxable year in which his death occurs. Distributions by the decedent's personal representative to beneficiaries of the decedent's estate would not give rise to a distribution deduction against the decedent's income. As under current law, income tax accrued through the date of the decedent's death would be deductible for Federal estate tax purposes.

The first taxable year of the estate as a separate entity would be the first taxable year beginning after the decedent's death. The estate would be subject to tax at a separate rate schedule, with no zero bracket amount and no personal exemption (or deduction in lieu of a personal exemption), but with a deduction for distributions to beneficiaries. Although the estate would not be entitled to any personal exemption, an estate having gross income of less than $600 would be exempt from Federal income tax liability and would not be required to file a return (as under present law).

An estate would compute its taxable income in the same manner as any trust following the death of the grantor. Thus, the estate would be entitled to a deduction for distributions that carry out DNI, and such distributions would be taxable to the beneficiaries. For this purpose, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. As under present law, distributions that are made in satisfaction of a bequest or gift of specific property or a specific sum of money would not carry out DNI.

## Effective Date

The proposal would apply to estates of decedents dying on or after January 1, 1986.

## Analysis

By placing estates on the same taxable year as the decedent, the proposal would eliminate the selection of a taxable year for an estate that defers the taxation of the estate's income. Continuing the

decedent's final taxable year through the last day of the year in which the decedent's death occurs would simplify the Federal income tax returns of most decedents and their estates, and would also permit simpler rules for taxing inter vivos trusts created by the decedent. See Ch. 3.14. Providing the estate with a separate rate structure and a deduction for distributions would continue some income-shifting opportunities that exist under present law; however, placing all trusts created by the decedent on the same calendar year and applying a strict multiple trust rule would limit the use of trapping distributions to shift income from estates to trusts.